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# AUDIT REPORT



AUDIT OF THE PHILADELPHIA DEPARTMENT OF  
COMMERCE'S LOAN ASSISTANCE TO THE URBAN  
EDUCATION DEVELOPMENT RESEARCH AND  
RETREAT CENTER (UEDRARC) REHABILITATION  
PROJECT  
PHILADELPHIA, PENNSYLVANIA

2001-PH-1006

AUGUST 1, 2001

OFFICE OF AUDIT, MID-ATLANTIC  
PHILADELPHIA, PENNSYLVANIA

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Issue Date August 1, 2001
Audit Case Number 2001-PH-1006

TO: Joyce Gaskins, Director, Office of Community Planning and Development, Mid-Atlantic, 3AD

FROM: Daniel G. Temme, District Inspector General for Audit, Mid-Atlantic, 3AGA

SUBJECT: Audit of the Philadelphia Department of Commerce's Loan Assistance to the Urban Education Development Research and Retreat Center (UEDRARC) Rehabilitation Project

We completed an audit of the City of Philadelphia's loan assistance to UEDRARC, a non-profit entity providing educational and human development services. The audit included loan activity administered by two delegate agencies under the Philadelphia Department of Commerce: the Philadelphia Industrial Development Corporation (PIDC) and the Philadelphia Commercial Development Corporation (PCDC). This report focuses on our audit of PIDC's loans and the loan servicing and monitoring practices that relate to the UEDRARC Project. The conditions we observed regarding the PCDC loan were addressed in a separate report that we issued on November 2, 2000.

Within 60 days, please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us with copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact J. Phillip Griffin, Assistant District Inspector General for Audit, at (215) 656-3401, extension 3490.

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# Executive Summary

We completed an audit of the City of Philadelphia's Community Development Block Grant (CDBG) and Section 108 funding of the Urban Education Development Research and Retreat Center (UEDRARC) Rehabilitation Project, administered through its delegate agency, the Philadelphia Industrial Development Corporation (PIDC). The objectives of the audit were to determine whether PIDC:

- Ensured HUD funds for the UEDRARC Project met a national objective;
- Awarded the CDBG and Section 108 funds to UEDRARC in accordance with HUD's requirements, as well as its own loan policies and procedures; and
- Effectively administered the CDBG and Section 108 loans provided to UEDRARC.

Although we determined the UEDRARC Project did meet a national objective consistent with HUD's CDBG criteria, the project was never financially viable. PIDC disregarded its own loan policies and procedures, as well as HUD's requirements, in funding this high-risk project. In addition, the City of Philadelphia and PIDC neither provided the necessary oversight to ensure performance goals were achieved, nor monitored UEDRARC's use of funds for compliance with loan requirements.

Since UEDRARC began operations in 1993, it has not been able to generate sufficient rental income to cover its long-term debt and operating expenses. In fact, all loans PIDC provided to UEDRARC quickly became delinquent and two of the loans were used to repay several delinquent loans. At the end of our review, UEDRARC's three outstanding loans totaling \$4,650,000 were either delinquent or defaulted. Under its present financial structure, it is doubtful UEDRARC will be able to repay these loans and sustain its operations for the long-term. Further, PIDC (1) did not apply approximately \$1.5 million in credits to the CDBG Program for State reimbursements of contractor invoices, originally paid with HUD funds, and (2) used a Section 108 loan of \$800,000 for ineligible purposes. Finally, we found UEDRARC used \$604,235 of its funds to pay for questionable expenses rather than pay its contractors \$526,514 of eligible construction expenses. The primary issue areas are summarized below and detailed in the Findings section of this report.

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## PIDC Disregards Own Policies and HUD Requirements To Fund UEDRARC Project

PIDC loaned UEDRARC, a non-profit organization, CDBG and Section 108 funds totaling \$5,450,000 to fund a high-risk project that was not financially viable. Even though members of PIDC's Executive Committee expressed reservations about the financial aspects of the project, the Executive Committee authorized the loans based on the project's potential service to the community. We found PIDC: (1) often did not follow its normal loan policies and procedures and HUD requirements in approving, processing, and servicing the UEDRARC loans; (2) did not provide the necessary project oversight to ensure

UEDRARC achieved performance goals and used HUD funds according to the program requirements; and (3) had not developed and implemented written policies and procedures for the review, award, and administration of the loans. Further, the City of Philadelphia did not adequately monitor PIDC operations to ensure HUD program funds were used appropriately. As a result, UEDRARC defaulted on all loans almost immediately, and its ability to repay these loans and sustain its operations is doubtful unless it obtains significant capital contributions.

**PIDC Did Not Apply CDBG Credits For State Reimbursements**

UEDRARC submitted the same \$2,379,934 in contractor invoices for payment from HUD loans and reimbursement from State funds. HUD funds were disbursed first and then used as payment evidence to obtain State reimbursement. Since the State reimbursed UEDRARC for invoices that were originally paid with HUD CDBG funds, any rebate must be credited to the HUD program either as a cost reduction or cash refund. PIDC neither credited the CDBG Program nor ensured UEDRARC used the reimbursements for future costs. Since PIDC did not have documentation to support \$1,513,394 in disbursements of State reimbursements, we questioned these costs.

**Section 108 Funds Were Not Used For Eligible Activities**

Contrary to Federal regulations, PIDC used Section 108 funds to repay a delinquent CDBG loan previously provided to the loan recipient. This occurred, in part, because the City of Philadelphia did not provide adequate oversight over its delegate agency's program administration. Thus, \$800,000 of Section 108 funds were used for ineligible purposes.

**Loan Funds Were Used For Questionable Purposes**

PIDC did not adequately account for and disburse funds it provided to the UEDRARC Project to ensure the funds were used only for authorized and eligible purposes. This occurred because PIDC did not (1) maintain any written policies and procedures for the financial management and disbursement of program funds; (2) monitor UEDRARC's use of funds; and (3) disburse funds to dual payees. Additionally, the City of Philadelphia did not adequately monitor PIDC's use of the funds it provided to UEDRARC. As a result, UEDRARC used \$604,235 in loan and grant funds to pay questionable expenses instead of paying its contractors \$526,514 of eligible construction expenses.

**Other Related Audit of the  
UEDRARC Project**

In a related audit conducted by our office, we determined that the City of Philadelphia also lent another \$550,000 in HUD CDBG funds, through PCDC, another City delegate agency funded under the Philadelphia Department of Commerce. We reviewed the PCDC loan and detailed those results in a separate audit report issued November 2, 2000 (01-PH-241-1001). Similarly, our review noted loan award and monitoring deficiencies including the bypass of normal procedures and lack of enforcement of the loan agreement.

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**Recommendations**

We recommend the City of Philadelphia require PIDC to: (1) develop and implement written up-to-date policies and procedures for the approval, award, and administration of loans; (2) determine whether \$604,235 in questionable account transfers and check disbursements were paid for eligible and authorized purposes; (3) reconcile and determine all outstanding amounts due to the UEDRARC Project contractors; (4) provide assurance that any HUD-funded activities properly credit the HUD Program and maintain proper documentation to support disbursements by funding source; and (5) calculate the amount of State funds that should have been treated as CDBG credits, and return that amount, from non-Federal funds, to its line-of-credit. We also recommend that the City of Philadelphia repay the \$800,000 that was used to repay a delinquent CDBG loan, to the Section 108 account and ensure all future Section 108 funds will be used only for eligible purposes.

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**Auditee Comments**

We discussed the results of our review with PIDC representatives during the audit, and with PIDC and City representatives at an exit conference on July 9, 2001. We reviewed the audit results, including the issue of applicable credits and ineligible and questionable costs, with managers and staff from HUD's Pennsylvania State Office, Office of Community Planning and Development. Both HUD management and HUD-OIG agreed upon the criteria used to determine applicable credits, ineligible and questionable costs, and the other matters included in the report. In May 2001, we provided PIDC and the City of Philadelphia with copies of our draft report and solicited their comments. By

letter, dated June 29, 2001, the Philadelphia City Representative/Director of Commerce provided a detailed response to the findings and recommendations discussed in the draft report. We summarized the City's comments in the Finding section of this report, and included the City's response, without attachments, in Appendix A.

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## Abbreviations

CDBG	Community Development Block Grant
HUD	US Department of Housing and Urban Development
OHCD	Office of Housing and Community Development
OMB	Office of Management and Budget
PAID	Philadelphia Authority for Industrial Development
PCDC	Philadelphia Commercial Development Corporation
PIDC	Philadelphia Industrial Development Corporation
UEDRARC	Urban Education Development Research and Retreat Center
UEF	Urban Education Foundation

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# Introduction

The U.S. Department of Housing and Urban Development provides CDBG and Section 108 funds to the City of Philadelphia (Grantee) for various purposes. The Office of Housing and Community Development (OHCD) for the City of Philadelphia applies for and obtains this funding. OHCD assigns a portion of the CDBG and Section 108 funds to Philadelphia's Department of Commerce for economic development projects. The City's Department of Commerce then provides these funds to its delegate agencies, PIDC and PCDC, to administer. The Philadelphia Department of Commerce must approve loans before they can be made by PIDC and PCDC, and is responsible for ensuring all Federal requirements are satisfied.

UEDRARC was founded as a non-profit organization to:

- Acquire the property at 4601 Market Street,
- Rehabilitate the buildings,
- Restructure the facility's governance and management, and
- Attract appropriate new tenants.

UEDRARC is comprised of a 12 member Board of Directors. In 1993, UEDRARC took control of the property at 4601 Market Street after the prior owner, Urban Education Foundation (UEF), filed for bankruptcy. UEDRARC developed a reorganization plan to purchase and redevelop the property. On December 29, 1993, a private lender provided a \$1.6 million loan to UEDRARC. UEDRARC agreed to pass the funds to UEF to pay creditors and payroll, and to set up a loan interest reserve for UEDRARC to repay the bank. UEDRARC subsequently defaulted on the loan. From 1995 through 1997, UEDRARC turned to the City for financial support and obtained over \$10 million in funds from various sources including Federal, State, and local entities. Altogether, PIDC and PCDC awarded UEDRARC \$6,000,000 in CDBG and Section 108 loans which they administer.

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## Audit Objectives

The primary objectives of the audit were to determine whether PIDC:

- Ensured the UEDRARC Project accomplished a national objective;
- Ensured UEDRARC met its goals, accounted for all funds, and used the funds for appropriate purposes;
- Awarded the CDBG and Section 108 funds to UEDRARC in accordance with HUD requirements and its own loan policies; and,
- Effectively administered its CDBG and Section 108 funds according to applicable laws, HUD's

regulations, loan documents, and other applicable directives. Specifically whether PIDC:

- ◆ Managed systems and controls to provide effective oversight for the project;
  - ◆ Monitored UEDRARC operation and rehabilitation procedures;
  - ◆ Accounted for all funds provided to the project;
  - ◆ Validated UEDRARC's inability to make loan payments; and
  - ◆ Took appropriate action to make loan payments current.
- Objectively evaluated the feasibility of the UEDRARC Project, including:
    - ◆ Determining if the UEDRARC Project was an effective use of CDBG and HUD Section 108 funds; and
    - ◆ Determining if UEDRARC had the financial means to sustain its operations for the long-term.

### Audit Period

We performed audit work from January 2000 to December 2000, and covered the period January 1992 through November 2000.

### Audit Scope and Methodology

We evaluated PIDC's procedures and controls over its loan approval, accounting, and monitoring processes to determine whether they were effective and properly administered. This included a review of PIDC's accounting records to determine whether all funds to UEDRARC were properly distributed, accounted for, and used for appropriate purposes. In addition, we interviewed PIDC managers and staff to determine the actual procedures used to award, administer, and monitor the UEDRARC loans and to disburse and account for the funds provided.

We reviewed UEDRARC's:

- Compliance with the terms and conditions of the PIDC loan agreements;
- Consultant's procedures and controls for tracking construction costs, and compiling bills during the

construction process to determine whether effective controls were in place; and

- Construction and operation accounting processes to determine whether UEDRARC accounted for all funds received, used the funds for appropriate purposes, and to determine UEDRARC's current financial position.

Further, we reviewed the Commonwealth of Pennsylvania's records pertaining to the nine grant disbursements for the UEDRARC Project to determine the documentation provided to the State. We interviewed managers to determine the State's procedures for reviewing reimbursement requests and disbursing funds.

We conducted the audit in accordance with generally accepted government auditing standards.

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## PIDC Disregarded Its Own and HUD'S Requirements To Fund A High-Risk Project

PIDC loaned UEDRARC, a non-profit organization, CDBG and Section 108 funds totaling \$5,450,000 to fund a high-risk project that was not financially viable. Even though members of PIDC's Executive Committee expressed reservations about the financial aspects of the project, the Executive Committee authorized the loans based on the project's potential service to the community. We found PIDC often did not follow its normal loan policies and procedures and HUD requirements in approving, processing, and servicing the UEDRARC loans. Also, PIDC (1) did not provide the necessary project oversight to ensure UEDRARC achieved performance goals and used HUD funds according to the program requirements; and (2) had not developed and implemented written policies and procedures for the review, award, and administration of the loans. Further, the City of Philadelphia did not adequately monitor PIDC operations to ensure HUD program funds were used appropriately. As a result, UEDRARC defaulted on all loans it was provided almost immediately. At the end of our review, it had three outstanding loans totaling \$4,650,000 that were either delinquent or defaulted. UEDRARC's ability to repay these loans and sustain its operations is doubtful unless it obtains significant capital contributions.

### NDF and Section 108 Loan Program

The City of Philadelphia distributes its CDBG funds to various agencies, including PIDC, for varied purposes. PIDC operates a number of loan programs to promote economic growth within the City of Philadelphia, including the Section 108 Program and the Neighborhood Development Fund (NDF), which it used to fund the loans to UEDRARC. The NDF is part of PIDC's Economic Stimulus Program funded through the CDBG Program. Its purpose is to promote economic growth and stabilize communities. The HUD Section 108 Loan Program also promotes economic development. This program provides long-term fixed rate financing to businesses that cannot access sufficient, comparable conventional financing.

### HUD Requirements

Guidance on the Grantee's responsibilities in administering CDBG funds is addressed in Title 24 CFR 85.40 (a) and Title 24 CFR 570.501 (b). Specifically, Title 24 CFR 85.40 (a) states that Grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved.

Title 24 CFR 570.501 (b) provides that the Grantee is responsible for ensuring that CDBG funds are used in accordance with all program requirements. The use of designated public agencies, subrecipients, or contractors does not relieve the recipient of this responsibility. The recipient is also responsible for determining the adequacy of performance under subrecipient agreements and procurement contracts, and for taking appropriate action when performance problems arise.

In addition, each mortgage and security agreement between PIDC and UEDRARC provides requirements for monitoring purposes and details various remedies available if a loan recipient fails to pay its mortgage.

**PIDC Loan Guidelines Were Not Followed**

Although PIDC did not have written policies and procedures over its loan approval process, PIDC officials did explain the procedures they usually followed to process and approve their loans. However, PIDC managers constantly reminded us that UEDRARC was “atypical” and they did not always apply these procedures to this non-profit entity. For example, PIDC did not maintain check lists of approval steps and require formal application packages and loan documents for every UEDRARC loan.

**PIDC Executive Committee Members and Staff Questioned Financial Viability of UEDRARC**

Further, members of the Executive Committee expressed reservations about the financial viability of the project, and PIDC’s staff later questioned the project’s qualifications for Section 108 funding. PIDC’s Executive Committee eventually awarded these loans based on the project’s potential for service to the community and strong support locally.

**PIDC Provided UEDRARC With Generous Funding at Favorable Terms**

PIDC provided UEDRARC with six loans and one grant over a three-year period funded through HUD, State, and local monies as follows:

<b>Loan Number Or “Grant”</b>	<b>Loan Or Grant Amount</b>	<b>Award Date</b>	<b>Type of Loan/Grant</b>
Pennsylvania Grant	\$3,500,000	9/29/94	PA Redevelopment Assistance Capital Program
2274-01-01	\$750,000	3/29/95	HUD-NDF
2274-02-01	\$800,000	3/29/95	HUD CDBG (I)*
2274-02-02	\$1,600,000	3/29/95	City (I)*
2274-02-03	\$100,000	12/23/96	City (I)
2274-03-01	\$3,100,000	2/26/97	HUD - Section 108
2274-04-01	\$800,000	5/30/97	HUD – NDF
<b>TOTAL</b>	<b>\$10,650,000</b>		
(I) = Interim Loan * = Loans repaid in 1997 by HUD Section 108 loan.			

As the table above illustrates, the State of Pennsylvania was the first to award funds to UEDRARC through a grant from its Redevelopment Assistance Capital Program in 1994. PIDC’s Philadelphia Authority for Industrial Development (PAID) division administered the grant. In addition to the State grant, PIDC awarded \$7.15 million in other loans to UEDRARC from March 1995 through May 1997.

When UEDRARC failed to make the loan payments on the three initial loans, PIDC provided additional financing in 1997 with two more HUD-funded loans. Specifically, PIDC provided a \$3.1 million HUD Section 108 loan to UEDRARC to repay the two outstanding PIDC interim loans (\$1.6 million, used to repay a defaulted private loan, and \$800,000); create debt, construction, and architectural reserves; and pay additional construction related expenses. Then, PIDC issued a new \$800,000 HUD-NDF loan to pay further construction costs. PIDC used the construction and architectural reserves to make the first seven mortgage payments, for UEDRARC, on the Section 108 loan. Stated otherwise, PIDC set up these reserves to repay itself.

In addition to providing a steady stream of funding, PIDC also offered UEDRARC other favorable terms. We noted that the CDBG NDF loans to UEDRARC featured terms more favorable than those granted other recipients of PIDC

loans, including interest rates of only 3 ¼ percent (normally 3 ½ to 4 percent), and 120 month moratoriums (normally not provided) on principal payments as shown below:

Loan Type	Loan Date	Loan Amount	Interest Rate (%)	Int.Only Period (Months)
Interim <u>1/</u>	03/29/95	\$ 800,000	3 ¼	120
Permanent	03/29/95	\$ 750,000	3 ¼	120
Permanent	05/30/97	\$ 800,000	3 ¼	120

1/ Repaid by HUD Section 108 loan.

**PIDC Did Not Adequately Monitor the Project**

The City of Philadelphia did not ensure PIDC administered the NDF and HUD Section 108 loans, provided to UEDRARC, according to the provisions of its loan agreements and HUD requirements. Also, PIDC did not enforce the terms of its loan agreements that required UEDRARC to submit annual audited financial statements.

The Mortgage and Security Agreements for each PIDC loan require UEDRARC to submit rent roll information within 15 days of PIDC's request and audited financial statements to PIDC within 90 days after the end of its fiscal year. Further, although PIDC did not have written policies and procedures over its loan monitoring and default processes, PIDC officials told us their procedures included a review of the borrowers' financial statements and rent rolls as was required in the loan agreements.

PIDC officials maintained they constantly requested loan payments, rent rolls, and audited financial statements from UEDRARC, but received little or no response to their requests. However, we found no documentation of these actions before 1999. Specifically, we found one rent roll dated August 1999 and PIDC provided a 2000 rent roll during our audit. PIDC obtained audited financial statements for the years ending 1997 and 1998, on May 17 and July 21, 2000, respectively, and did not have audited financial statements for 1999 and 2000. Without such information, PIDC could not assess UEDRARC's financial condition.

PIDC's computer system also provides monitoring information in the form of delinquency notifications to the Vice President of Lending. The Vice President of Lending takes action based on the severity of the delinquency notification. As described by the Vice President of Lending, PIDC normally takes the following actions when a loan becomes delinquent or goes into default.

- 90 days delinquent, PIDC's in-house counsel contacts the client to provide notice of default. If the situation is not cured within 10 days, PIDC takes legal action.
- Over 90 days delinquent, the Vice President of Lending forwards the file to PIDC's outside counsel to begin legal action against the company and the guarantors. The Senior Vice President of Special Projects will visit the company to determine the value of any real estate collateral. PIDC may also employ professional appraisers, auctioneers, brokers, and environmental professionals to determine values.

We found that PIDC did not enforce any of these actions on its loans to UEDRARC. Further, the Special Conditions and Modifications to the Contract for Loan Guarantee Assistance Under Section 108 of the Housing and Community Development Act of 1974, requires the Borrower (City of Philadelphia) to ensure that the parties involved in the loan process diligently perform administrative procedures normally involved in approving and monitoring loans. Based on our review, it does not appear the City complied with this provision.

#### PIDC Failed To Respond To UEDRARC's Default

The Mortgage and Security Agreements for each of the interim and permanent NDF and HUD Section 108 loans to UEDRARC outlined actions available to PIDC upon default, including but not limited to:

- Contacting UEDRARC's accountants,
- Declaring the entire loan immediately due and payable,
- Taking possession of the premises, and
- Seizing rents.

These agreements state that late fees and service charges apply. Also, the HUD Section 108 Mortgage Note stated that any default on the NDF loans was considered a default on the Section 108 loan. Title 24 CFR Part 570.501 provides that grant recipients take appropriate action when performance problems arise. These actions include issuing letters of warning, requesting corrective action proposals, establishing and following a management plan, and suspending disbursement of funds for the deficient activity.

When UEDRARC defaulted on its loans, PIDC did not enforce any of the recourses available under its loan agreements. Although PIDC sent letters requesting payment and restructured some of the loans, these actions were not conducted promptly and were ineffective. For example, UEDRARC defaulted on the first NDF loan in December 1995, but the first letter we found where PIDC addressed any delinquency or default action was dated May 4, 1999. The letter to UEDRARC's Treasurer requested payments on the Section 108 loan plus detailed revised payment schedules for the NDF and Section 108 loans. In April 2000, PIDC met with a member of UEDRARC's Board, who is also a State Senator, and negotiated a deferral of delinquent interest and late fees on the HUD Section 108 and NDF loans. PIDC has yet to analyze UEDRARC's financial condition to determine its ability to make loan payments or prospects to become current at some future date.

#### Outstanding Loans Are Delinquent/Defaulted

There are three outstanding loans to UEDRARC from PIDC. Because of UEDRARC's financial difficulties, PIDC waived over \$130,000 of interest and fees on all loans (current & closed), and, in May 2000, deferred over \$340,000 in interest and fees on the three active loans. In addition, PIDC deferred all payments for the \$750,000 and the \$800,000 NDF loans until December 2000. The status of all loans is illustrated below.

**CURRENT LOANS**

<b>Loan Type</b>	<b>Loan Amount</b>	<b>Deferred Interest and Fees</b>	<b>Waived Fees</b>
NDF	\$ 750,000	\$ 63,180	\$2,149
NDF	800,000	66,712	2,224
HUD 108 Permanent	3,100,000	218,849	
Total	\$4,650,000	\$348,741	\$4,373

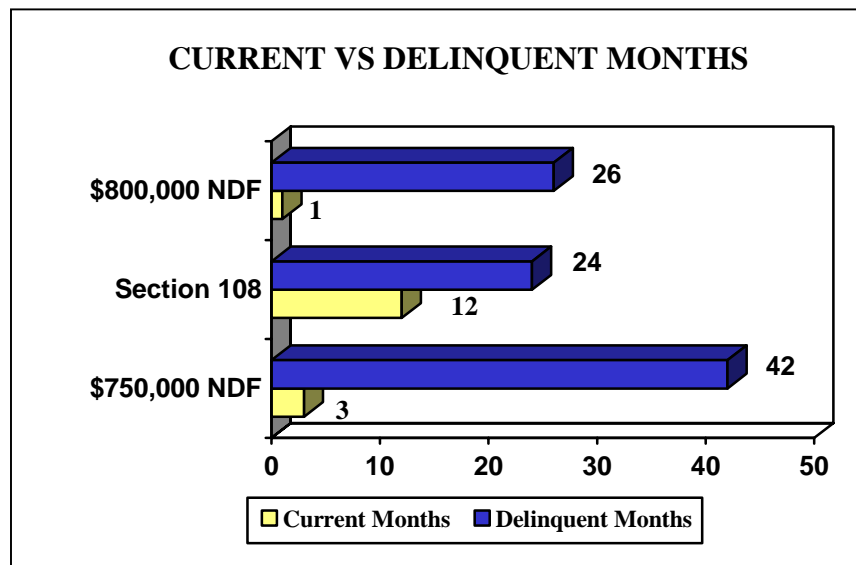
**CLOSED-OUT LOANS**

<b>Loan Type</b>	<b>Loan Amount</b>	<b>Waived Interest and Fees</b>
OHCD Interim	\$1,600,000 1/	\$ 91,625
NDF Interim	800,000 1/	32,654
PIDC Interim	100,000 2/	1,500
Total	\$2,500,000	\$125,779

1/ Loan repaid using HUD Section 108 loan.

2/ Loan repaid using the State of PA reimbursement.

At the end of our audit, all three outstanding loans were delinquent/defaulted. However, PIDC does not recognize these loans as “delinquent” or “defaulted” because they are restructuring them again. We do not agree with this position. The following graph depicts the severity of this indebtedness by displaying the actual number of months UEDRARC was current on each of the outstanding loans versus the number of months it was delinquent.



Although this graph gives the appearance that UEDRARC made an effort to pay the Section 108 loan, as discussed previously, PIDC set up construction and architectural reserves that provided the first seven months' payments on this loan.

UEDRARC's Prospects As A  
Going Concern Are  
Questionable

Although UEDRARC met a CDBG National Objective of eliminating a slum and blighted condition, its ability to sustain this success in the long term is doubtful. Further, by failing to repay its CDBG and Section 108 loans, UEDRARC continues to tie up funds that could be used to fund other projects.

We reviewed UEDRARC's unaudited records and found it does not generate sufficient rental income to meet its long-term debt and operating expenses. UEDRARC's financial operations over a 17 month period from January 1999 through May 2000, are summarized below:

	Monthly Average	17 Month Total
Operating Expenses without loan pmt <u>1/</u>	\$139,355	\$2,369,034
Loan Payment <u>2/</u>	36,890	627,132
Total Expenses <u>1/</u>	176,245	2,996,166
Revenue <u>1/</u>	151,572	2,576,727
Shortfall	(\$ 24,673)	(\$ 419,439)
<u>1/</u> Revenue and expense amounts were obtained from UEDRARC's accounting system and are unaudited. Expenses included utilities, payroll, and maintenance costs. <u>2/</u> Amount includes payments to PIDC and PCDC.		

Further, UEDRARC lacks the necessary resources needed to renovate the entire fifth floor of the project's building (including asbestos removal). The new space is needed to generate additional rental income to sustain its operations. Also, our analysis above does not include \$526,514 owed to various contractors for unpaid construction work (Finding 3). Without sufficient resources, UEDRARC will not be able to sustain itself for the long term.

In summary, we believe that PIDC did not act responsibly by continually loaning funds to a project that it knew, or should have known, could not meet its obligations. Under the circumstances that existed, PIDC did not follow its normal loan procedures and continued to fund the project, while ignoring its delinquent and defaulted history, provided more favorable terms than usual, advanced loan funds without commitment, and failed to adequately monitor UEDRARC and enforce the provisions of its loan agreements. Also, the City did not adequately oversee PIDC's program administration.

## Auditee Comments

The City disagreed that there were no written policies and procedures. The City provided copies of PIDC policies and procedures, dated 1986, and Provider Agreements, dated January 1996 and 1998, which it said updated the procedures. Further, it stated that the Provider Agreements between PIDC and the City, governing the UEDRARC loans, provide agreed upon written procedures as a component of the Monitoring and Compliance sections. Finally, the City directed PIDC to develop a "Loan Procedure

Manual” for distribution to staff, loan committee members, and Board members. PIDC is preparing the document and expects to complete it by September 1, 2001.

The City advised us that it, PIDC, PCDC, and UEDRARC have reached an agreement in principle for restructuring the outstanding debt and contractor payments. The restructuring agreement enables UEDRARC to repay its public debt, while still acting as an anchor to future development in the community. Income projections do not include additional leasing space from the fifth floor or income from anticipated land sales, which the City believes have a good chance of coming to fruition. The City provided us with the restructuring plan, which includes a City funded \$600,000 loan to pay off outstanding contractor debt, restructuring the outstanding loans again, and providing PIDC and PCDC with 50 percent of UEDRARC’s net cash flow until the CDBG loans are repaid. The agreement also requires UEDRARC to provide monthly financial statements until it repays the loans.

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#### OIG Evaluation of Auditee Comments

The City’s comments are noted. However, several times during the audit, we asked responsible PIDC managers for a copy of their policy and procedures manual, or other written procedures governing their loan review, award, and administration. In all cases, PIDC’s managers stated that no written procedures existed. Further, PIDC’s managers stated that they did not follow normal procedures for the UEDRARC Project and provided us with verbal explanations of their procedures. Providing a 1986 Policy and Procedures Manual, with revisions, at the end of the audit is not the issue, since PIDC’s managers were not aware of it or using it. When PIDC develops and implements the “Loan Procedures Manual” containing the elements mentioned in the OIG recommendation, City and PIDC oversight should improve and prevent the conditions noted in the finding from reoccurring.

Once again, the City and PIDC are restructuring UEDRARC’s loans and providing additional funding. The projected income and expense pro forma 2001-05 Forecast, provided with the City’s comments, appears to support the City’s view that the plan is viable. However, pro formas used in the past also made the UEDRARC Project appear

viable, but PIDC never had audited financial statements with which to compare them. Although the proposed agreement requires monthly financial statements, the City still has not required audited financial statements. Also, the City did not mention that the UEDRARC Project does not have the funding to renovate the fifth floor to provide additional leasing space. Further, the proposed restructuring agreement requires UEDRARC to provide PIDC and PCDC with 50 percent of the net positive cash flow. During the period we reviewed, UEDRARC did not have a net positive cash flow. Finally, the City did not address the actions it will enforce if UEDRARC fails to comply with its loan agreements. Since PIDC never enforced any available recourse under the existing loan agreements, this is a concern.

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## Recommendations

We recommend that HUD direct the City to require PIDC to:

1A. Develop and implement written policies and procedures that fully describe:

- The process PIDC will observe for the review, evaluation, and approval of all loan requests;
- Monitoring methods PIDC will employ to ensure project objectives are being achieved; and,
- Actions PIDC will take in the event a loan recipient defaults.

In addition, these policies and procedures should detail when exceptions would be warranted, what exceptions will be allowed, and require staff to document in writing the exceptions and rationale for granting such.

1B. Determine its current and future plan for the success of this project and develop agreements and recourses that the City will enforce when UEDRARC fails to comply with its agreements.

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# PIDC Did Not Ensure Section 108 Funds Were Used Only For Eligible Activities

Contrary to Federal regulations, PIDC used Section 108 funds to repay a delinquent CDBG loan previously provided to the loan recipient. This occurred, in part, because the City of Philadelphia did not provide adequate oversight over its delegate agency's program administration. As a result, \$800,000 of Section 108 funds was used for ineligible purposes.

## HUD Requirements

Title 24 CFR 570.703, "Eligible Activities", states that guaranteed loan funds (under Section 108) may be used for a variety of activities. This section specifies "...guaranteed loan funds may not be used to reimburse the CDBG program account or line-of-credit for costs incurred by the public entity or designated public agency and paid with CDBG grant funds or program income."

## PIDC Used Section 108 Funds to Repay Delinquent CDBG Loan

PIDC awarded the UEDRARC Project \$3.1 million in HUD Section 108 funds in 1997 (see Finding 1 for Numerous Funding Sources). The Section 108 loan was used for a number of purposes, including to establish debt, construction, and architectural reserves; pay various settlement costs; and repay two PIDC interim loans previously provided to UEDRARC, in 1995. PIDC funded one of these two interim loans, in the amount of \$800,000, under HUD's CDBG Program.

Thus, PIDC did not comply with the Section 108 loan program requirements when it used Section 108 funds to repay a CDBG loan. Therefore, PIDC used the Section 108 funds for ineligible purposes.

## Auditee Comments

The City disagreed with our recommendation to repay \$800,000 to the Section 108 account. The City emphasized that its oversight of the UEDRARC Project complied with regulatory requirements. The City believes the \$800,000 interim assistance loan, which it says we described as ineligible in the report, was an eligible use of CDBG funds, since there are no statutory or regulatory prohibitions for using CDBG funds for interim assistance funding. Further, the City stated that the 24 CFR 570.703 prohibition on using Section 108 proceeds applies only against the CDBG

Program account or line-of-credit. The City stated that during the interim assistance period, PIDC did not draw any CDBG funds from the City's program account.

The City stated that no additional Federal funds have been proposed for the UEDRARC Project. Also, all new projects are reviewed pursuant to 24 CFR 570.703, and no interim CDBG loans have been provided to Section 108 loan recipients.

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OIG Evaluation of  
Auditee Comments

We did not question the eligibility of the \$800,000 CDBG interim assistance. However, we did question the eligibility of the HUD Section 108 funds used to repay the interim assistance loan. PIDC used program income to fund the CDBG interim assistance loan because regulations prohibited drawing funds from the program account when program income is available. Program income is still CDBG money that eventually goes to the program account. The fact that PIDC did not draw CDBG funds from the City's physical program account is irrelevant. Paying off the \$800,000 interim assistance loan with HUD Section 108 funds is still an ineligible use of the funds.

The City's action to review all new projects based on 24 CFR 570.703 should help prevent HUD Section 108 funds being used for ineligible purposes in the future.

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Recommendations

We recommend that HUD ensure the City of Philadelphia:

- 2A. Repay \$800,000 to the Section 108 account and use the funds for future eligible purposes.
- 2B. Ensure PIDC has not and/or will not use other Section 108 funds for ineligible purposes similar to the UEDRARC loan.

# PIDC Needs To Improve Its Financial Management of Funds

PIDC did not adequately account for and disburse funds it provided to the UEDRARC Project. Thus, PIDC did not ensure the funds were used only for authorized and eligible purposes according to HUD regulations and its loan and grant agreements. This occurred because PIDC did not (1) maintain any written policies and procedures for the financial management and disbursement of program funds; (2) monitor UEDRARC's use of funds; and (3) disburse funds to dual payees. Additionally, the City of Philadelphia did not adequately monitor PIDC's use of the funds to UEDRARC. We found PIDC did not apply approximately \$1,513,394 in credits to the CDBG Program for State reimbursements of contractor invoices, originally paid with HUD funds. In addition, UEDRARC used \$604,235 of loan and grant funds to pay questionable expenses instead of paying \$526,514 for eligible construction costs from its contractors.

## HUD Requirements

Title 24 CFR 85.20 (b) states the financial management systems of other grantees and subgrantees must meet the following standards:

- (1) "...Financial Reporting. Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.
- (2) Accounting records. Grantees and subgrantees must maintain records, which adequately identify the source and application of funds provided for financially-assisted activities. These records must contain...obligations, unobligated balances, assets, liabilities, outlays or expenditures, and income....
- (6) Source documentation. Accounting records must be supported by such source documentation as cancelled checks, paid bills, payrolls, time and attendance records, contract and subgrant award documents, etc...."

Title 24 CFR 85.40 (a) states that Grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved.

Title 24 CFR 570.501 (b) provides that the Grantee is responsible for ensuring that CDBG funds are used in accordance with all program requirements. The use of designated public agencies, subrecipients, or contractors does not relieve the recipient of this responsibility.

Title 24 CFR 570.506 (h) “Financial Records” requires the City to maintain evidence to support how it used the CDBG funds it received. Such documentation should include invoices, schedules containing comparisons of budgeted amounts and actual expenditures, construction progress schedules signed by appropriate parties, and/or other documentation appropriate to the nature of the activity.

OMB Circular A-87, Attachment A, Subsection C.4.a., describes applicable credits as follows:

“Applicable credits refer to those receipts or reduction of expenditure-type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs. Examples of such transactions are: purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments of overpayments or erroneous charges. To the extent that such credits accruing to or received by the governmental unit relate to allowable costs, they shall be credited to the Federal award either as a cost reduction or cash refund, as appropriate.”

#### PIDC Loan/Grant Requirements

Each loan and grant agreement, between PIDC and UEDRARC, details how loan and grant funds are to be used. Specifically, all agreements allow disbursed funds to be used for acquisition and construction costs. In addition, two agreements permitted the repayment of prior loans (see Finding 2 for ineligible repayment of loan).

#### Review of Records from Multiple Sources

UEDRARC received \$10,650,000 in funding through Federal, State and local sources (Finding 1). We reviewed the disbursements from all sources to ensure:

- Support documentation existed for all disbursements to UEDRARC;
- The same invoices were not used to draw down both HUD and State funds; and

- Invoices were not paid twice under different funds.

In order for UEDRARC to draw down available HUD funds, it was required to submit to PIDC its unpaid contractor invoices that supported each draw request. For UEDRARC to obtain reimbursements from the State, it was required to submit the contractor invoices and evidence of payments to the Philadelphia Authority for Industrial Development (PAID), PIDC's division that administers State monies. Thus, we were concerned that the same contractor invoices may have been used to draw down both HUD and State funds, and PIDC may have paid the same contractor invoice more than once due to the multiple funding sources used to reimburse or pay contractor costs. To satisfy our concerns, we completed a review of PIDC's accounting records.

Our review disclosed PIDC did not maintain support for \$3,097,793 in Federal, State, and local disbursements. Thus, we continued our audit by reviewing the Commonwealth of Pennsylvania, UEDRARC, and its consultant, Urban Partners' records.

**PIDC Did Not Apply CDBG Credits For State Reimbursements**

From the State's records, we determined UEDRARC had submitted \$1,929,934 in contractor invoices for both payments from the HUD loans and reimbursements from the State funds. In addition, another \$450,000 in acquisition costs were paid with HUD funds and also reimbursed by the State. HUD funds were disbursed and then used as evidence of payment to obtain the State reimbursement. When we asked PIDC staff whether they were concerned with disbursing funds twice for the same contractor invoices, they told us that PIDC trusted UEDRARC to use the State reimbursements for future construction costs.

Since the state made reimbursements on invoices that were originally paid, with HUD CDBG funds, Federal requirements (OMB Circular A-87, Attachment A, Subsection C.4.a) provide that any rebate be credited to the HUD program either as a cost reduction or cash refund. Not only did PIDC not credit the CDBG Program, but it failed to ensure the reimbursements were used for future construction costs. Since PIDC had no supporting

documentation for \$1,513,394<sup>1</sup> in disbursements of State reimbursements, we questioned these costs.

To ensure that UEDRARC used the funds as required by the PIDC loan and grant agreements, we continued our review of available documentation from Urban Partners and UEDRARC. Unfortunately, Urban Partners' records were limited and did not provide us all the necessary information. In addition, UEDRARC's records were not complete. Numerous bank statements and cancelled checks were missing. Due to the incompleteness of its records, UEDRARC authorized its financial institution to release its construction account information for our audit. The results of our review of UEDRARC's records follow.

UEDRARC Used Loan and Grant Funds For Questionable Purposes

While we did not find any duplicate payments to contractors, we did note that UEDRARC did not disburse all HUD funds to the contractors for the submitted invoices. We determined that UEDRARC transferred \$383,535 to other UEDRARC accounts (operating and payroll) instead of disbursing it for construction costs. In addition, UEDRARC used over \$220,700 (via checks) to pay various operating and other questionable expenses, including but not limited to, utilities, landscaping, consulting, and fundraising fees. For example, UEDRARC disbursed:

- Two checks totaling \$50,000 to the "Fund for Pennsylvania";
- Over \$9,000 to UEDRARC's current Treasurer, for fund-raising purposes; and
- \$10,000 to an entity named Citizens Alliance.

Further, UEDRARC's bank records disclosed that it did not always use funds it drew down to pay invoices submitted to PIDC. For example, on March 23, 1995, PIDC disbursed \$306,865 of HUD loan funds to UEDRARC to pay various contractors. UEDRARC used \$141,569 to pay those applicable contractors and \$148,073 to pay other costs, including utility bills and security fees. UEDRARC did not

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<sup>1</sup> Unsupported costs are calculated as follows: [\$1,929,934 (contractor invoices submitted to the State) x 55.1% (State reimbursement rate)] + \$450,000 (acquisition cost) = \$1,513,394.

disburse the remaining \$17,223 until after receipt of the next loan installment.

#### UEDRARC Has Unpaid Contractor Costs

Since we questioned the reliability of information UEDRARC provided to us, we requested confirmations from the 10 principal contractors that conducted work at the project to verify the amount of invoices and any unpaid balances that remained. The 10 contractors reported that UEDRARC paid them \$6,036,447 (through July 2000) and still owed \$526,514. Our discussions with PIDC officials disclosed that PIDC was not aware of any outstanding debts payable to UEDRARC's construction contractors.

UEDRARC disbursed funds to the private lender and to pay operating and other unauthorized expenses because PIDC failed to monitor how the funds were being used. Also, we noted PIDC never used dual payees when disbursing funds. In some cases PIDC could not use dual payees because UEDRARC submitted multiple contractor invoices. However, there were several disbursements that paid for only one contractor's invoices.

In summary, had the City of Philadelphia and PIDC properly managed and controlled the funds provided to the project, UEDRARC would not owe \$526,514 to its contractors. The City and PIDC would also have realized that UEDRARC was using loan and grant funds for operating expenses and other liabilities that UEDRARC did not disclose. With this information, the City should have realized the financial shortcomings of this endeavor, which in turn, may have affected the City's decision to provide additional loans in 1997 (Finding 1).

#### Auditee Comments

The City stated that PIDC's Policy and Procedures Manual has been in existence since the mid-1980's. However, the City admitted the Manual needs updating to reflect staffing changes, a new computerized accounting system, and the fact that many CDBG forms are automatically generated by PIDC's loan management system. The City stated PIDC's policy has always been to monitor borrowers to ensure they used funding for authorized purposes.

The City determined that there were no questionable costs involved in the UEDRARC Project based on its Certified Public Accountant's preliminary review of PIDC files. This

review identified documented expenses of \$8,822,000, which exceeded PIDC and PCDC permanent loan and grant funds provided to UEDRARC by more than \$100,000. The City also pointed out that, based on discussion with UEDRARC's Treasurer, two of the questionable checks listed in the report were repayments of interim construction loans to private entities, and were therefore, legitimate construction costs. PIDC normally disburses funds on a reimbursable basis as a subordinate lender, which would not require dual payee checks. Since there was no senior lender for the UEDRARC Project, PIDC advanced loan funds based on AIA documentation.

UEDRARC provided the City with a list of all vendor payables. As of March 2001, construction debt totaled \$475,071, pre-construction debt totaled \$80,000, and post-1995 debts totaled \$660,641. The City will address the payables in the restructuring agreement between PIDC, PCDC, and UEDRARC.

Based on its review of PIDC records, the City claimed that sufficient systems are in place to document and track HUD-funded programs. However, PIDC agreed that its procedures manual needs updating. PIDC expects to complete updating its uniform program management system by September 1, 2001.

The City disagreed that PIDC should treat the State funds as CDBG credits. The City maintained that all of the CDBG funds and State Redevelopment Capital Assistance Program grant funds were used for eligible project costs. The City also pointed out that the State hired a firm to review the grant and that firm found the project to be satisfactory overall.

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#### OIG Evaluation of Auditee Comments

As we commented in Finding 1, PIDC managers told us they had no written procedures and did not follow normal procedures, which they verbally explained to us, for the UEDRARC Project. The fact that the City provided a Policy and Procedures Manual from the 1980's is not an issue, since PIDC's managers either did not know about it or did not use it. Further, the City did not address whether PIDC's revised manual, when implemented, will provide policies and procedures to: maintain adequate documentation, monitor

recipients to ensure authorized use of funds, and use dual checks when reasonable.

We accepted AIA documents or contractor invoices as adequate documentation for fund disbursements, but the disbursements in question lacked this support. Further, we identified the questionable transfers and disbursements by reviewing UEDRARC's construction account check register and cancelled checks. Reviewing PIDC records would not provide much information concerning these transactions. In addition, we do not consider a statement by UEDRARC's treasurer to be sufficient documentation of a valid use of funds. We also noted numerous other questionable disbursements that either did not identify the goods and services obtained or listed questionable commodities.

Although PIDC advanced funds directly to UEDRARC based on AIA documentation, PIDC had no control to ensure UEDRARC used the funds for valid construction costs. To date, the City has not provided support to show it has determined whether the questionable disbursements and transfers were eligible and authorized.

Although UEDRARC provided the City with a list of vendor payables, the City did not indicate whether they had reconciled the list and determined its accuracy. Since the OIG obtained different amounts from the vendors directly, we would expect the City to compare and resolve any discrepancies.

Our review of PIDC records for the UEDRARC Project did not indicate that PIDC adequately used its systems to document and track the Project. If PIDC updates and implements its uniform management system, it should enable the City and PIDC to accurately account for all funded activities.

Since HUD funds paid for \$1,929,934 of the invoices submitted to PAID for State reimbursement, Federal requirements provide any rebate be credited to the HUD Program. Further, the City did not provide support for its statement that UEDRARC used all of the CDBG funds and the State Redevelopment Grant funds for eligible project costs. Upon receipt of State reimbursement checks, PAID issued its own check directly to UEDRARC, but did not have

a control to ensure that it used the funds for authorized purposes. Without reviewing UEDRARC's records, the City could not know how it used the funds. The State hired the consulting engineering firm to monitor the Project's progress. The firm reviewed one payment and validated that UEDRARC had paid the invoices submitted, but did not attempt to verify that UEDRARC actually used the reimbursement for authorized purposes.

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## Recommendations

We recommend that HUD direct the City of Philadelphia to require PIDC to:

- 3A. Develop and implement a financial management system that provides for written policies and procedures for all of its programs to guide staff to:
  - Maintain adequate documentation to support the full amount of disbursements made to program recipients;
  - Monitor recipients to ensure they use the funds for authorized purposes; and,
  - When reasonable, use dual payee checks to issue funds to program participants.
- 3B. Determine whether the \$383,535 in questionable account transfers and the \$220,700 in questionable check disbursements were paid for eligible and authorized purchases consistent with Federal requirements. Repay to the program, from non-Federal funds, any disbursement deemed ineligible.
- 3C. Reconcile and determine all outstanding amounts due to any contractor that performed work on the UEDRARC Project.
- 3D. Ensure its financial management system accurately accounts for all activities funded by HUD, whether alone or in conjunction with other sources, properly credits the HUD Program, when applicable, and maintains proper documentation for all disbursements.

- 3E. Determine whether the \$1.5 million in unsupported costs can be properly accounted for and calculate the amount of State funds that should have been treated as CDBG credits. Return any amount due, from non-Federal funds, to its line-of-credit.

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# Management Controls

Management controls consist of a plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies. Management controls include the processes for planning, organizing, directing, and controlling program operations. They contain the control environment for risk assessment, information systems, control procedures, communication, and measuring and monitoring program performance.

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## Relevant Management Controls

In planning this audit, we evaluated the PIDC management controls related to our objectives to determine our audit scope and procedures. We determined the following management controls were relevant to our audit objectives:

- Loan approval policy and procedures to ensure PIDC evaluated the feasibility of the UEDRARC Project, including whether the UEDRARC Project: was an effective use of CDBG funds; affected a national objective; and had the financial means to sustain its operations;
- Loan administration and accounting policy and procedures to ensure PIDC had the systems and controls to monitor the project; used the controls to monitor the project; and accounted for the funds provided; and
- Policies and procedures to ensure that PIDC administered HUD funds in accordance with applicable laws, HUD regulations, loan documents, and other directives.

## Significant Weaknesses

A significant weakness exists if management controls do not give reasonable assurance that the entity's goals and objectives are met; that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

Our audit disclosed the following significant weaknesses:

- PIDC did not observe loan administration policies and procedures, including monitoring requirements and default procedures (See Finding 1).
- PIDC used Section 108 funds for ineligible activities (See Finding 2).
- PIDC did not ensure that UEDRARC used loan and grant funds for appropriate purposes (See Finding 3).
- PIDC did not maintain documentation for loan disbursements (See Finding 3).

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## Follow Up On Prior Audits

No recent audits have been conducted of the City of Philadelphia's Department of Commerce or PIDC. In addition, no outstanding recommendations exist for either of these agencies.

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# Auditee Comments



## CITY OF PHILADELPHIA

JAMES J. CUORATO  
City Representative and  
Director of Commerce

June 29, 2001

Daniel G. Temme, District Inspector General for Audit  
U.S. Department of Housing and Urban Development  
The Wanamaker Building, Suite 1005  
100 Penn Square East  
Philadelphia, PA 19107-3380

RE: US DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (HUD)  
INSPECTOR GENERAL FOR AUDIT REPORT: PHILADELPHIA DEPARTMENT OF  
COMMERCE – URBAN EDUCATION DEVELOPMENT RESEARCH AND RETREAT  
CENTER (UEDRARC)

Dear Mr. Temme:

In response to your letter of May 29, 2001, and the above referenced draft audit, we have reviewed the document. We want to emphasize that the City's oversight of this project was in compliance with the regulatory requirements. Specifically, the UEDRARC project was reviewed for the following elements on January 29, 1997:

1.	Fundability Requirement:	Satisfactory	<u>X</u>
2.	Eligibility Requirements:		
	Eligibility Description:	Satisfactory	<u>X</u>
	Appropriate Determination:		
	24 CFR 570.209 Ratio Per Assisted Job:		<u>\$27,083</u>
	Non-Federal Non-Substitution:	Satisfactory	<u>X</u>
	CDBG Determination Form:	Satisfactory	<u>X</u>
	Financial Analysis Form:	Satisfactory	<u>X</u>
	Financial Ratio Evaluation:	Satisfactory	<u>X</u>
3.	Employment Reporting Requirements:	Completed	<u>X</u>
4.	Fundability Requirements:	Completed	<u>X</u>
5.	Employment Information Requirements:	Completed	<u>X</u>
6.	Environmental Review Requirements:	Submitted	<u>X</u>

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james.cuorato@phila.gov  
(215) 683-2001

7.	Labor Standards Requirements:	Completed	<u>X</u>
8.	Financial Information Requirements:	Completed	<u>X</u>
9.	Local Benefit Analysis:	Completed	<u>X</u>
10.	Reasonability of Cost Requirement:	Completed	<u>X</u>

A copy of the review material is attached hereto for your information as Attachment "A".

The Urban Education Center project was determined to eligible under Section 24 CFR 570.204(a) of the HUD regulations. All federal funds were included in this review, as well as the other project costs. There is no statutory prohibition from using Community Development Block Grant funds to provide "interim assistance" financing. Neither is there a regulatory prohibition from utilizing CDBG funds to provide "interim assistance" financing under Subpart C. Therefore, we firmly believe that the \$800,000 interim assistance loan as described in the draft report as ineligible is **eligible**.

Further, the draft report's basis for this ineligibility finding is based upon the language in Subpart M, 24 CFR 570.703. Under this section it clearly states that Section 108 proceeds may not be used to "reimburse the CDBG program account or line of credit". The interim assistance loan made to UEDRARC was not drawn from the City's program account nor was it drawn from the City's letter of credit.

With regard to **Recommendation 1A**, we disagree with the claim that there are not written policies and procedures. Attached are copies of written policies and procedures that date to 1986. (See Attachment "B".) Further, the agreements between PIDC and the City governing the UEDRARC loans are attached and clearly spell out agreed upon written procedures as a component of the Monitoring and Compliance sections. (See Attachments "C" and "D".) However, the City has directed PIDC to develop a singular "Loan Procedure Manual" for distribution to staff, loan committee members and Board members. PIDC is preparing this document. (See Attachment "E".)

With respect to **Recommendation 1B**, the City, PIDC, PCDC and UEDRARC have reached an agreement in principle for the restructuring of the outstanding debt and the payment of contractors. (See Attachments "F" and "G".) Under this agreement, UEDRARC will be able to repay its public debt, while still acting as an anchor to future development in this impacted community. Further, the out year income appears to be conservatively based with little-to-no projected rent increases. The income projections do not include additional leasing of space (primarily on the fifth floor) nor does it include income from the land sales anticipated from retail expansion expected along Market Street. All of these have a good chance of coming to fruition.

The City Disagrees with **Recommendation 2A**. As stated above, at the time that the Section 108 Loan was approved, it was found to be in compliance with the appropriate regulations. At the direction of the HUD Washington office, the PIDC prepared the CDBG Fundability/ Eligibility Determination under the 24 CFR 570.200 section of the CDBG regulations. Under those provisions, there is no regulatory prohibition from the provision of interim loans. Further, the prohibition on using the Section 108 proceeds under 24 CFR

570.703 applies only against the "program account or line of credit". The interim construction loans provided to UEDRARC by PIDC did not affect the City's CDBG "program account". During the period that the loans were outstanding, PIDC did not draw any CDBG funds from the City's program account.

With respect to **Recommendation 2B**, no additional federal funds have been proposed for the UEDRARC project. As directed from the HUD Philadelphia Office, all new projects are reviewed pursuant to 24 CFR 570.703. Since funding the UEDRARC, no interim CDBG loans have been provided to Section 108 Loan recipients.

Under Finding 3, the report refers to checks written by UEDRARC to the "Fund for Pennsylvania" and the "Citizens Alliance". Both of those entities provided interim construction lending to UEDRARC and those checks were repayments, according to James Baker, the UEDRARC Treasurer. With respect to **Recommendation 3A**, PIDC's CDBG Policy and Procedures Manual has been in existence since the mid-1980's and is attached. However, it needs to be updated to reflect changes in staffing and the use of a new computerized accounting system (Solomon). It also needs to be updated to reflect the fact that many of the CDBG forms are now automatically generated by PIDC's proprietary loan management system, Portfol. For your information, we are including our up-dated Lending and Delinquent Loan Procedures, our HUD 108 Guidelines and EZ Guidelines which were approved by HUD, and HUD Section 108 Loan Under-Writing Procedures.

It has always been PIDC's policy to monitor borrowers to ensure that approved funding is used for authorized purposes. In fact, in our typical role as subordinated lender it is our policy to disburse approved loan funds on a pro rata basis with other lenders subject to a 10% hold back or retention. Furthermore, such funds are advanced on a reimbursement basis subject to the borrower's providing paid invoices or cancelled checks thus eliminating the need for dual payee checks. In our typical transaction, a project is funded on a 50-40-10 basis. Fifty percent (50%) of the project funding is provided by a bank which generally has a senior lien on the project assets and any other collateral. Forty percent (40%) of the funding is provided by PIDC through one of its many financing programs and the balance of the project (10%) is financed by borrower equity. In this, PIDC's typical transaction, the PIDC senior lender drives the process. In other words, the bank normally makes a determination as to eligible project expenditures and advances payment accordingly. When an invoice has been paid by the bank, the borrower brings the paid invoice or cancelled check to PIDC for our 40% (less a 10% retention) reimbursement. The bank and PIDC normally require that any borrower equity be used prior to the advance of any loan funds. When the project has been completed, PIDC will pay out the 10% retention only after a staff member makes a site visit and determines that the project is complete.

In the case of UEDRARC there was no senior lender. Accordingly, loan funds were advanced, subject to a 10% retention, based upon project completion as evidenced by AIA standard documentation, which is customary even with banks.

Under **Recommendation 3B**, the Commerce Department's Certified Public Accountant has completed a preliminary review of the PIDC files and has documented expenses in excess of \$8,822,000. This amount exceeds the permanent loan and grants provided by PIDC and PCDC by more than \$100,000. (See Attachment I.) Based on this review, there were not any questionable costs documenting the disbursement of funds from the Section 108 Loan, the CDBG loans or the State grant.


Under **Recommendation 3C**, the City has received a list of all vendor payables from UEDRARC. These vendor payables shall be addressed in the work-out agreement between, PIDC, PCDC and UEDRARC.

Under **Recommendation 3D**, our review of the PIDC records confirms that sufficient systems are in place to document and track HUD funded programs. However, PIDC agrees that their procedural manual needs to be significantly up-dated.

Under **Recommendation 3E**, none of the State funds need to be treated as a CDBG credit. All of the CDBG funds and the State Redevelopment Capital Assistance grant funds were used for eligible project costs. The Redevelopment Capital Assistance Program is a reimbursement program. Accordingly, project expenditures paid for out of the CDBG loan were used as documentation to support the draw down of the State grant. The Redevelopment Assistance grant was thereafter used to pay other eligible project costs. Thus, the full amount of the CDBG loan and State grant were used to fund eligible project expenditures. Further, the State hired a firm to review the grant and that review found the project to be satisfactory overall. (See Attachment "J".)

I want to thank you in advance for your cooperation in this matter and we will be prepared to answer any questions at the Exit Conference scheduled for July 9, 2001, at 11:00AM.

Very Truly Yours,



JAMES J. QUORATO

cc: Mayor John Street  
Mjenzi K. Traylor  
Kenneth Trujillo

Joyce M. Gaskins  
Joyce Wilkerson  
Peter Longstreth

# Schedule of Questioned Costs

<u>Recommendation Number</u>	<u>Ineligible <u>1/</u></u>	<u>Unsupported <u>2/</u></u>
2A	\$800,000	
3B		\$ 604,235
3E		<u>1,513,394</u>
	<u>\$800,000</u>	<u>\$2,117,629</u>

- 1/ Ineligible amounts are those that are questioned because of an alleged violation of a provision of a law, Regulation, contract, grant, cooperative agreement or other agreement or document governing the use of funds, or are otherwise prohibited.
- 2/ Unsupported amounts are those whose eligibility or reasonableness cannot be clearly determined during the audit since they were not supported by adequate documentation or due to other circumstances. Under Federal cost principles, a cost must be adequately supported to be eligible.

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